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The Indonesian PSC: the end of an era

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ABSTRACT

In early 2017, Indonesia established a new form of production sharing contract, the Gross-Split PSC, which abolished the cost recovery system first pioneered by Indonesia in 1966. This article explores the history of the production sharing contract and some of the tensions associated with the traditional cost recovery system which contributed to such a radical and unexpected departure to the conventional PSC model. We analyse the salient features of the new 'Gross-Split' model and the uncertainties facing E&P companies and regulators as a result of its introduction. The architects of the new model have great expectations that it will restore investor confidence and expedite the development of reserves by granting contractors freedom to pursue investments without regulatory control over contracting procedures.

On 13 January 2017, the Ministry of Energy and Mineral Resources (*Kementerian Energi dan Sumber Daya Mineral*, the 'ESDM') of the Republic of Indonesia issued Regulation No. 8 of 2017 (the 'Gross-Split PSC Regulation'). Arguably, it is the most significant regulatory development in the history of Indonesia's oil and gas sector since Law No. 22 of 2001 concerning Oil and Gas ('Law 22 of 2001'). New production sharing contracts ('PSC') must comply with a new model PSC prescribed by the Gross-Split PSC Regulation. This model PSC (a 'Gross-Split PSC') dispenses with the cost recovery system which has been a feature of all Indonesian PSCs since their inception.[1]

Its sudden emergence surprised many industry participants and is largely the result of political considerations, which have been dominated by the declining share of Government of Indonesia ('Government') revenues from the oil and gas sector at a time of depressed global oil prices and declining production levels. This article analyses the reasons behind the abandonment of the PSC model by Indonesia for new PSCs and assesses whether or not the Gross-Split PSC model is likely to attract further investment in Indonesia's upstream sector and the challenges that need to be overcome in its implementation.

1. THE INDONESIAN PSC

Indonesia was the first country to enter into a PSC in 1966. Since then, the PSC model has been exported throughout the world.[2] The PSC permits countries to maintain sovereignty over their petroleum resources.

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1 Indonesia has adopted other contractual models besides the PSC, including Technical Assistance Contracts and the Cooperation Operation / *Kerjasama Operasi* (KSO) model for areas operated by Pertamina. These contractual models were not widespread and were analogous to service contracts within Pertamina's contract area and are not being renewed as they expire.

2 The production sharing model has been used in several countries, including Angola, Cambodia, China, Egypt, Equatorial Guinea, Ethiopia, Gabon, India, Liberia, Libya, Malaysia, Mauritania, Mongolia, Mozambique, Myanmar, Nigeria, São Tomé and Principe, Sudan, Syria, Tanzania, Timor-Leste, Trinidad and Tobago, Tunisia, Vietnam and Yemen.

International oil companies ('IOCs') act as contractors ('Contractors') to the host Government and assume exploration and development risk. Contractors recover their costs of exploration and development from a share of production if they make a commercial discovery and commence production.

The PSC developed in response to the concessions granted to IOCs in the Middle East and elsewhere in the first part of the 20th century. These concessions conferred rights to explore vast tracts of land for long periods, often in excess of 40 years, with almost complete discretion as to how and when the IOCs would conduct their activities. One of the few rights retained by the host government was the right to receive a royalty payment based on oil production. The lack of control enjoyed by host governments over the development of their oil and gas resources resulted in political dissatisfaction and, in some cases, nationalization. The PSC developed by Indonesia was seen as an increasingly popular alternative in balancing the needs of the host government and IOCs. When it was first introduced, the supermajors were opposed to its terms as they recognized the potential for it to set a dangerous precedent that could be used elsewhere in the world. However, there were a number of companies, primarily little-known US independents, that did not have the global reach of the supermajors who were willing to accept these terms.

The first Indonesian PSC was signed on 18 August 1966 in respect of the Offshore Northwest Java Block between Pertamina and the US independent company, Independent Indonesian American Petroleum Company (the 'ONWJ PSC'). The ONWJ PSC recently expired on 18 January 2017 (having been extended from its original 1997 scheduled expiry date). In one of the strange quirks of history, the ONWJ PSC became the first PSC to adopt the Gross-Split PSC framework.[3]

2. WHAT WAS WRONG WITH THE CONVENTIONAL PSC MODEL?

SKK Migas and oversight

The recovery by the Contractor of its capital and operating costs from production (the 'Cost Recovery System') is a unique feature of the PSC model, which differentiates it from other fiscal regimes. In return for permitting the recovery of these costs from production revenues, the Contractor is required to obtain the approval of the regulator for such costs. Unless such costs are incurred and approved in accordance with work programs and budgets, authorizations for expenditure ('AFE') requests and prescribed procurement guidelines and other laws and regulations governing the sector, they are ineligible for cost recovery once production commences.

Initially, when the PSC model was introduced in Indonesia, the oversight exercised over such costs by Pertamina (which was then the regulator empowered to administer cost recovery on the part of the Government) was relatively light as it was a national oil and gas company with fairly limited experience and so it developed a very collaborative relationship with Contractors. The Pertamina unit responsible for this oversight, the Foreign Contractor Coordinator Body or *BKKA*, became increasingly intrusive over time with respect to its oversight of operations and tensions developed between it and the Contractors it regulated. Consequently, when Law 22 of 2001 (Indonesia's current oil and gas law) was implemented, which, among other things, saw Pertamina stripped of its role of regulatory oversight, some industry participants welcomed the change as they hoped that there would be less oversight exerted by the fledgling BPMIGAS (the predecessor entity to the current regulator, SKK Migas), to which Pertamina's role was transferred. Unfortunately, the consensus view of Contractors working in the Indonesian upstream sector is that SKK Migas has become more difficult to deal with than Pertamina under the previous regime. In hindsight, this is not surprising. Operational oversight was assumed by a Government department that had no industry expertise and, consequently, the time for decision-making and obtaining approvals lengthened.

3 An agreement for the ONWJ Block to adopt the Gross-Split PSC was entered into on 18 January 2017 by Pertamina subsidiary, PT Pertamina Hulu Energy Offshore North West Java and the Gross-Split PSC is scheduled to expire on 18 January 2037.

Moreover, a series of regulations were implemented, that, in many cases, altered long-standing administrative practices, which led to a drastic curtailment of the types of costs that were eligible for recovery.[4] The risk of non-compliance with an ever-widening array of regulations and practices grew and for many industry participants their enthusiasm for exploration and development waned in an environment in which the focus swung from encouraging exploration and development to managing costs and developing the capabilities of local contractors through the procurement guidelines and procedures administered by SKK Migas. Most worryingly in recent times, there have been criminal cases brought against Contractors who are alleged to have violated cost recovery procedures and caused 'State losses', one of which resulted in the imprisonment of Contractor employees.[5]

The Government's reduced take

In 2016, cost recovery expenditures totalled US$11.4 billion, while the Government's revenue from the oil and gas sector was only US$9.29 billion.[6] In the latter part of 2016, the ESDM and Commission VII of the Indonesian House of Representatives (which oversees the energy and mining sector) demanded a further reduction of cost recovery budgets for 2017. SKK Migas had reportedly sought US$11.7 billion, but only US$10.4 billion was approved. ESDM officials asserted that high cost recovery expenditures resulted from the inefficiencies of oil and gas companies.[7] These budgetary pressures have put the Cost Recovery System and the industry under increasing strain, and the evolution of the Gross-Split PSC Regulation is a direct response to those pressures. The hope is that by allowing Contractors discretion as to how they will implement activities, they will find ways to reduce their operating costs in order to preserve their returns since they will no longer be reimbursed for such costs. While this principle is laudable, the reality is that the oil and gas field services sector in Indonesia is a relatively 'high cost' environment compared to other jurisdictions, so a transition to a lower cost operating environment is unlikely to occur overnight unless local service providers reduce their costs to compete with international service providers or local content requirements are relaxed.

Outside the industry, particularly in the media, there is a misconception that the Government is 'paying' for cost recovery rather than reimbursing Contractors for expenditures they have made. However, as one influential petroleum economist recently stated: '. . .to say that the government was "covering" the costs is misdirection. All systems "cover the costs" in one fashion or another either directly or indirectly'.[8] Unlike other industries, the PSC system does not allow a taxpayer to deduct expenditures from one PSC against income earned from another PSC, so unless and until there is production, the Contractor must bear those costs without any ability to deduct them from its taxable income—the PSC 'ring-fencing' principle.

4 For example, ESDM Regulation No 22 of 2008, implemented on 30 June 2008, set out a negative list detailing those costs which could not be recovered under the Cost Recovery System, including personal employee expenses (such as personal income tax), employee long-term incentive plans, marketing costs, environmental and community development costs post-exploration, procurement costs 10 per cent above permitted levels without justification, and losses arising from certain affiliate transactions. This was followed by Government Regulation No 79 of 2010 ('Regulation 79 of 2010') further restricting those costs recoverable under the Cost Recovery System, including, *inter alia*, tax consultancy fees, expatriate technical training costs, interest for debt finance and surplus materials.

5 See generally: Amanda Battersby, 'Chevron Worker Loses Case' *Upstream* (31 October 2014) <http://www.upstreamonline.com/hardcopy/news/997971/chevron-worker-loses-case> accessed 4 December 2017.

6 RambuEnergy, 'SKK Migas Says Investment in Upstream Oil and Gas Sector in 2016 Likely Below Target' *RambuEnergy* (6 December 2016) <https://www.rambuenergy.com/2016/12/skk-migas-says-investment-in-upstream-oil-and-gas-sector-in-2016-likely-below-target/> accessed 23 November 2017; SKK Migas, 'Oil and Lifting Exceeds the Target' (4 January 2017) <http://skkmigas.go.id/detail/1978/oil-and-gas-lifting-exceeds-the-target> accessed 23 November 2017; Roffie Kurniawan, 'Indonesia Issues Ruling on Gross-Split Scheme for New Oil and Gas Contracts' *RambuEnergy* (19 January 2017) <www.rambuenergy.com/2017/01/indonesia-issues-ruling-on-gross-split-scheme-for-new-oil-and-gas-contracts/> accessed 23 November 2017.

7 Fedina Sundaryani, 'Cost Recovery May Balloon in 2018' *The Jakarta Post* (29 August 2017) <www.thejakartapost.com/news/2017/08/29/cost-recovery-may-balloon-2018.html> accessed 23 November 2017.

8 Daniel Johnston, 'Changing fiscal landscape 2008–2017' (2017) 10 *Journal of World Energy Law and Business* 415–443, 427.

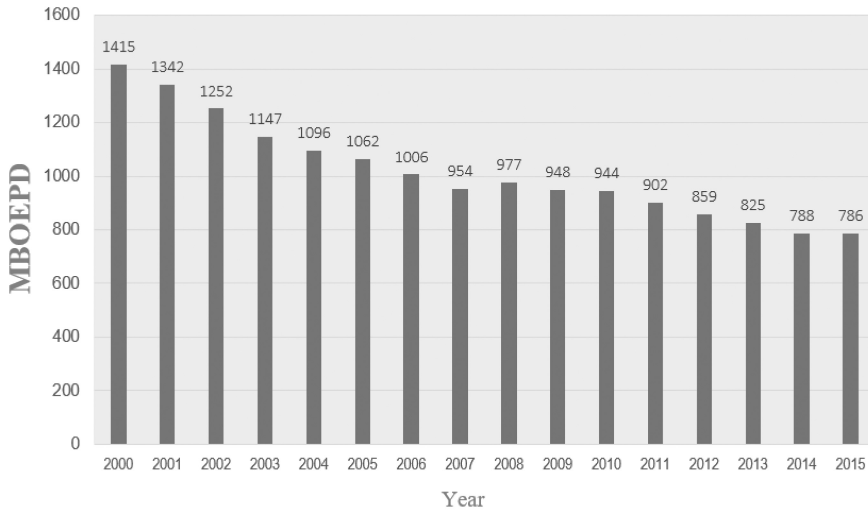

Figure 1. Indonesia oil production 2000–2015.
Source: IPA.or.id / SKKMigas.

As Figure 1 shows, Indonesia's oil production has been in steady decline, and this decline will continue as most of Indonesia's producing oil fields are in decline and, aside from a few exceptions, there have been very few recent major discoveries. The Minister of Finance, Sri Mulyani Indrawati, has stated that the Government expects production levels to steeply decline to 480,000 barrels per day by 2020.

While this is due to a number of factors, it is recognized that there has been a lack of investment in the sector and exploration has steadily declined in response to the worsening regulatory regime and unfavourable fiscal terms compared to other countries. In particular, the opportunities available in North America and Africa for unconventional and conventional exploration and development are now consuming billions of dollars of capital and operating expenditure and very little exploration has occurred in Indonesia.

As can be seen in Figure 2, exploration expenditures in the Indonesian upstream sector have been in decline since 2011.

The decline in production, coupled with reduced prices for such production, explains why the amount of costs available for recovery as against the Government's revenues from the sector is rising—the amount of operating costs incurred by the industry will be more or less stable; however, given there is declining production from which to recover those operating costs, the Government's take has been reduced accordingly. Revenues from the oil and gas sector declined from \$26.7 billion in 2014 to \$9.2 billion in 2016.[9]

3. GROSS-SPLIT PSC REGULATION

The Gross-Split PSC model introduced by the Gross-Split PSC Regulation splits gross revenues derived from hydrocarbon production between the Government and Contractors. Contractors must bear all capital and operating costs subject to such costs being tax deductible if commercial reserves are discovered and production generates taxable revenue. This is in contrast to the Cost Recovery System, which permitted the recovery of a share of production equivalent in value to such costs incurred by Contractors prior to the remaining revenue being shared with the Government based upon an agreed 'profit' split for oil and natural

9 John McBeth, 'Indonesia's Oil and Gas Prospects Running Dry' *Asia Times* (30 October 2017) <http://www.atimes.com/article/indonesias-oil-gas-prospects-running-dry/> accessed 23 November 2017.

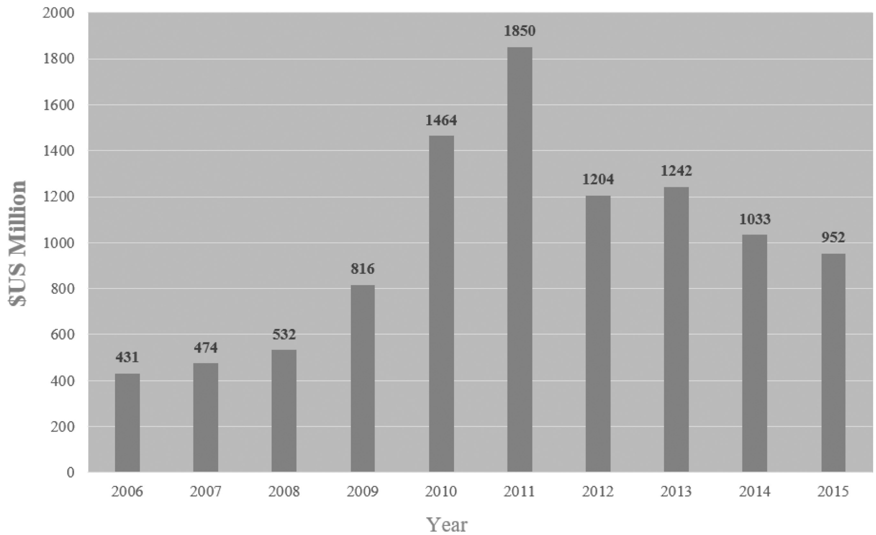

Figure 2. Indonesia investment exploration 2000–2015.
Source: IPA.or.id / SKKMigas.

gas. The idea of transforming the Indonesian PSC to a gross-split model was conceived as early as 2011.[10] We understand from our discussions with industry participants that they were only given limited time to comment on the draft Gross-Split PSC Regulation. While there were a series of meetings between the Indonesian Petroleum Association (the 'IPA'), the Director General of Oil and Gas/ESDM, MIGAS, SKK Migas and Pertamina in late 2016, there was ongoing debate with respect to the economics of the new fiscal regime compared to the traditional PSC regime and the focus was on the abolition of the Cost Recovery System to respond to political pressures. While the variable and progressive elements of the split do take into account various factors, an economic comparison between each type of contract can only occur if a particular project is modelled and the results are compared.

The Gross-Split PSC Regulation was hastily implemented in order to ensure that it could be used for the ONWJ PSC, which was scheduled to expire on 18 January 2017. It is unfortunate that more time was not taken by the Government and ESDM to refine the Gross-Split PSC Regulation and solicit comments from the IPA, E&P companies and other stakeholders.

Industry reaction to the Gross-Split PSC Regulation has been lukewarm, especially since there was no corresponding revision to the tax regulations to address the deductibility of expenditures in the oil and gas sector or any explanation provided as to the basis on which the various splits had been determined. Rumblings have already emerged from Commission VII of the House of Representatives, and several of its members have expressed concerns with the Gross-Split PSC Regulation.[11] The architects of the Gross-Split PSC model,

10 See Darmawan Prasodjo, Arcandra Tahar and Erwinsyah Putra 'Turning Petro Dollars Back On: A Game Theory Approach' *The Jakarta Post* (4 October 2011) <http://www.thejakartapost.com/news/2011/10/04/turning-petro-dollars-back-a-game-theory-approach.html> accessed 23 November 2017, in which the authors (Darmawan Prasodjo and Arcandra Tahar, who subsequently became the ESDM Deputy Minister) discuss the application of game theory to the Indonesian upstream oil and gas sector, the introduction of a royalty system and improving cost efficiencies.

11 For example, Dito Ganinduto has stated that the Gross-Split PSC Regulation will result in Contractors opting to use foreign technology and overseas workers to maximize profits. The Confederation of National Trade Unions (KSDN) has also voiced concerns regarding the inability of the Government to safeguard the welfare and employment of Indonesian employees in the sector (Retno Ayuningtya and Euis Rita Hartati, 'Government Plans To Replace Oil & Gas Cost Recovery Scheme in January' *Jakarta Globe* (10 December 2016) <http://jakartaglobe.id/commodities/govt-plans-replace-oil-gas-cost-recovery-scheme-january> accessed 23 November 2017).

Table 1. Gross-Split PSC provisions

• Government income • Conditions and timing for PSC extension • Abandonment obligations • Reporting requirements • Working area and relinquishment • Dispute resolution • Health and safety • Plans of development • Domestic market obligation • Disbursement of capital	• Prioritization of the employment of Indonesian manpower, and the use of Indonesian goods and services • Environmental management • Oil and gas production custody transfer • Assignments/transfers of rights and obligations • Community development and the guaranteeing of rights of indigenous communities

including ESDM Deputy Minister, Arcandra Tahar, have been attempting to defuse criticism of the regulation from a number of sources, including Pertamina who successfully lobbied for an increased profit split for the ONWJ PSC and has refused to accept the imposition of the model for various expiring PSCs until it has demonstrated that the Gross-Split fiscal terms are economic.[12] In response to the criticism, the ESDM introduced changes to the Gross-Split Regulation on 29 August 2017 pursuant to Regulation No. 52 of 2017 ('ESDM Regulation 52 of 2017'). The amendments improved certain of the variable split components in favour of the Contractor and, most importantly, replaced the additional split that may be granted by the Minister of Energy and Mineral Resources (the 'Minister') (discussed further below) from a maximum of 5 per cent to whatever amount the Minister decides.[13]

Model form

Article 2(1) of the Gross-Split PSC Regulation states that the 'Minister shall determine the format and basic provisions of a Gross-Split Production Sharing Contract'. Accordingly, until there is a form that has been approved and issued by the Minister, its precise terms are unknown. As far as we are aware, as at the date of this article, a model form Gross-Split PSC does not exist so it is unsurprising that the current bid round has stalled. The areas that are required to be addressed in the Gross-Split PSC resemble those used in the traditional PSC (and the basic provisions set out in Article 11(3) of Law 22 of 2001) and these are set out in Table 1.[14]

A number of provisions which exist in current generation PSCs will need to be removed or modified in order to reflect the principles prescribed in the Gross-Split PSC Regulation. While some of these are implicit (such as the removal of sections pertaining to the recovery of Operating Costs or First Tranche Petroleum), some are more nuanced. For example, the requirements that a change of operatorship or Change of Control of a Contractor party do not result in material additional costs and expenses may no longer be relevant as the risk of increased costs is borne by the Contractor.

12 The ESDM relented and awarded Pertamina an additional profit split for ONWJ in August 2017. This was reported to be a 73.5 per cent split for oil (which was initially set at 57.5 per cent) and 81 per cent for gas (which was initially set at 62.5 per cent)—although the precise basis for this increase is not clear. It was reported to be based on the movement of oil prices, cumulative production and the ESDM exercising its discretion to award an additional split up to the 5 per cent cap which existed under the Gross-Split PSC Regulation prior to it being revised by ESDM Regulation 52 of 2017. The expiring PSCs for each of the following blocks are to be replaced with Gross-Split PSCs: Tuban, Sanga-Sanga, Southeast Sumatra, Ogan Komering, North Sumatra, Tengah, East Kalimantan and Attaka. Pertamina is still conducting economic feasibility studies for these blocks, but has announced that it does not wish to take-over the East Kalimantan PSC and Attaka PSC using the Gross-Split PSC model due to the unfavourable fiscal terms. It is an indictment of the Gross-Split PSC model that Indonesia's national oil and gas company, Pertamina, has rejected its application. The response of ESDM has been to declare that other companies can 'bid' for these PSCs Pertamina has rejected, but it remains to be seen if other companies will reach a different view on their economics.

13 Article 7(1), Gross-Split PSC Regulation.

14 Table 1 sets out the areas which are required to be addressed in a Gross-Split PSC as set out in the Gross-Split PSC Regulation.

Table 2. Base-split percentage

	Contractor	*Government*
Oil	43%	57%
Gas	48%	52%

Split calculation

The Gross-Split PSC Regulation provides that gross production of oil and gas is to be divided between the Contractor and the Government based on different percentages for oil and gas production. The base split percentages are specified in Table 2,[15] which are then adjusted according to a number of variables as described below.

- **Base Split**. The base split percentage is adjusted by reference to: (i) variable components and (ii) progressive components. We have set out the variable and progressive components in Table 3 at the end of this article. The actual splits are determined by the Minister, based on the proposal from SKK Migas, when the first plan of development ('POD') is approved, subject to the discretion of the Minister who can propose an additional split if warranted by the economics of the block.[16] Interestingly, the splits to be used for subsequent developments are not determined by the Minister and are decided by the Chairman of SKK Migas. If a different split is determined by SKK Migas for subsequent developments, the Minister must approve the difference.[17] It is unclear what economic threshold will be used by the Minister to exercise discretion to improve the split and, in the absence of any objective criteria, this will make it difficult for Contractors to have confidence that the fiscal terms will support development at the time they enter into a Gross-Split PSC.
- **Variable Components**. Variable components adjust the base split percentages. These include the achievement of the first POD, and other factors such as the location of the relevant field, the depth and type of the reservoir, CO_2 and H_2S content and compliance with local content requirements.
- **Progressive Components**. There are two progressive components: (i) the level of the Indonesian Crude Price and gas price and (ii) cumulative oil and gas production, which cause the percentage split to fluctuate.

Table 3 at the end of this article sets out each of the variable and progressive components.

Greater split for cost-intensive projects

Given the existence of variable components which increase the Contractor's entitlement based on how far offshore the field is located, reservoir depth, the availability of supporting infrastructure and its stage of production (eg whether it is secondary or tertiary recovery), the gross-split mechanism recognizes the more challenging economics that apply to projects which are remote or where there are likely to be greater development costs. With respect to non-conventional reservoirs, the additional split entitlement of 16 per cent is considerable, although, to date, there has not been any meaningful level of development of unconventional resources in Indonesia for a variety of reasons.

15 Table 2 sets out the base split percentages for oil and gas which form the starting point for determining the Contractor's final entitlement under the Gross-Split PSC.

16 Article 8, Gross-Split PSC Regulation.

17 Article 16(3), Gross-Split PSC Regulation.

Tax deductibility of operating costs

Article 14 of the Gross-Split PSC Regulation provides that operating costs incurred by Contractors are deductible for income tax purposes. The 'Uniformity Principle' under the traditional Indonesian PSC meant that those costs that were recoverable under the Cost Recovery System were also tax deductible. Now that the Cost Recovery System has been abolished, the status of the 'Uniformity Principle' is unclear. Presumably, any costs which were previously cost recoverable should continue to be treated as being tax deductible in addition to any other costs incurred by the Contractor, even if they would not have been cost recoverable, provided such costs are incurred in accordance with an approved work program and other prevailing laws and regulations that continue to apply to the oil and gas sector. However, pursuant to the general income tax law, tax losses can only be carried forward for five years. Clearly, this is not sufficient for exploration costs as it may take much longer than five years for development to commence and generate sufficient revenues to fully deduct exploration, appraisal and development expenditures. The industry has sought clarification on this matter, but the Ministry of Finance has not implemented any regulations to extend the loss carry-forward period. It is reported that the period may be extended to 10 years, but this may be insufficient and contrasts unfavourably with the Cost Recovery System in which there is no time limit to recoup unrecovered costs.

The transition from a cost recovery regime to a general corporate income tax regime is problematic. Contractors will require guidance as to what expenses are tax deductible and an assurance that new taxes will not be introduced that could jeopardize project economics. It is not known if 'freezing' or tax stabilization provisions will be included in the model Gross-Split PSC or if Contractors will be exposed to changes in prevailing income taxes or the imposition of new direct or indirect taxes. Article 14 states that deductions from income are to be 'in accordance with the provisions set out in laws and regulations within the taxation sector which address upstream Oil-and-Gas business activities', which suggests that Contractors may be exposed to changes in tax laws.

It is inexplicable why the tax regime for Gross-Split PSCs was not implemented together with the Gross-Split PSC Regulation. It has been reported that the corporate income tax rate may be reduced for the Gross-Split PSC regime.[18] In addition, it is expected that taxes during the exploration period may be waived.[19] Either way the absence of these tax regulations has made it impossible for the industry to fully evaluate the Gross-Split PSC model and resulted in confusion and uncertainty.

Domestic market obligation

The Gross-Split PSC Regulation abolishes the requirement for Contractors to supply crude oil to the Indonesian domestic market at a discounted price and permits Contractors to receive the Indonesian Crude Price.[20]

4. A DYNAMIC SPLIT?

The Gross-Split PSC Regulation also contemplates adjustments to the splits based on actual performance/returns enjoyed by a Contractor during the life of a project, including:

- an adjustment to the gross-split allocation by the ESDM based on a 'commercial evaluation';
- variances between those components factored into a POD and the reality of subsequent field developments; and
- monthly adjustments based on Indonesian oil prices.

18 Fedina Sundaryani, 'Govt and Investors Don't See Eye-To-Eye on Gross-Split Taxation' *The Jakarta Post* (27 September 2017) <www.thejakartapost.com/news/2017/09/27/govt-and-investors-don-t-see-eye-eye-gross-split-taxation.html> accessed 23 November 2017.

19 Amanda Battersby, 'Indonesia Draws up Rule to Clarify Tax Regulations' *Upstream* (11 October 2017) <www.upstreamonline.com/hardcopy/1361606/indonesia-draws-up-rule-to-clarify-tax-regulations> accessed 23 November 2017.

20 Article 17(3), Gross-Split PSC Regulation.

Commercial evaluation

Article 7 of the Gross-Split PSC Regulation provides for an upward or downward adjustment if a certain economic value is not met for a field for which a POD or subsequent POD has been approved. How this economic value/level is determined is unclear. It is possible that these matters have been deliberately left vague to allow for negotiation on such points at the time a POD is submitted for approval, but this could be problematic since the absence of any guideline as to what is an acceptable rate of return for a development could lead to prolonged negotiations. There is no limit as to the amount of the level of the adjustment which the Minister may make, meaning that the Minister has complete discretion as to the percentage by which the Contractor's production split should be adjusted if the economic value of a field or fields either fails to meet or exceeds a certain economic value/level. While this flexibility may appear attractive at face value, it vests considerable discretion in SKK Migas and the Minister. We understand that the Director General of Oil and Gas has been instructed to develop guidelines in order to ensure that everyone has the same understanding vis-à-vis the commercial evaluation, which begs the question why those guidelines were not developed prior to issuance of the regulation.

Actual condition of variable and progressive components

Article 8(3) provides that where there are differences between the variable and progressive components factored into the relevant POD or further field developments and the 'actual condition' of such components, then 'a production share adjustment shall be done with reference to the actual conditions after commercial production'. While such adjustments are understandable in relation to certain variable components (eg if CO_2 content is different from that envisaged), it is unclear if this will apply to the progressive components ie cumulative production and changes in oil and prices.

Oil and gas prices

Article 9 provides that the percentage split is to be adjusted every month based on movements in the Indonesian Crude Price and gas prices. While this appears a more equitable arrangement between the Contractor and the Government (ie when prices are high, the Government's share increases and, when oil prices are low, the Contractor's share increases), it results in unpredictability given the volatility of prices.

5. ASSET OWNERSHIP—NO COST RECOVERY AND YET NO OWNERSHIP FOR CONTRACTORS

Under a PSC, equipment and other assets purchased for the purposes of operations become the property of the Government even though they are depreciated by Contractors. Historically, this made sense given that the costs of sourcing goods and equipment would be reimbursed through the Cost Recovery System and, to the extent the Government's share of production was reduced, it was in substance purchasing the assets on an instalment basis from the Contractor. Despite the abolishment of the Cost Recovery System, the Gross-Split PSC Regulation still provides that all goods and equipment become the property of the Indonesian State.[21] It is not clear why the position should be any different from other industry sectors in the absence of cost recovery and, logically, the Contractor should retain title to all assets and equipment it purchases. We understand from industry participants that asset ownership was raised during the limited period of engagement with the authorities for the original Gross-Split PSC Regulation. If this is not addressed, we expect that Contractors will continue their preference to lease equipment, where possible, which is unlikely to reduce operating costs.

21 Article 20, Gross-Split PSC Regulation.

6. WHAT IS THE ROLE OF SKK MIGAS NOW IT NO LONGER ADMINISTERS COST RECOVERY?

Reduced Oversight of Financial and Procurement Functions

One of SKK Migas' principal functions was the oversight and management of the Cost Recovery System through the approval of PODs, AFEs, work program and budgets and its administration of procurement activities.

Contractors must still submit a work program and budget to SKK Migas, although SKK Migas is only required to approve the work program and the budget is simply provided as supporting data for the work program.[22] The implication of the language used is that SKK Migas does not have a right to approve the budget, although how can a work program be approved without reference to an underlying budget? While Contractors had tended to inflate their budgets in order to avoid the need to seek further approvals from SKK Migas and to prevent arguments over cost recovery in the case of overruns, the new system raises many questions as to how SKK Migas can administer the sector without any control over a budget, which appears to be for informational purposes only.

Article 23 of the Gross-Split PSC Regulation states that SKK Migas is to have 'control and oversight over the execution' of the PSC, but the 'control' is 'limited to formulating policies on the work program and budget', and the 'oversight' is to be conducive 'to the realization of Contractor main operational activities including Exploration and Exploitation activities in accordance with the approved work program'.[23]

How SKK Migas will exercise these functions given the nebulous description of its oversight role is unclear. If the intent of the Gross-Split PSC Regulation is to allow the Contractor to operate in the most cost-efficient manner and to free it from the regulatory processes previously imposed by SKK Migas, the reservation of a broad role of oversight is inconsistent with this objective. SKK Migas has been stripped of its ability to regulate AFEs and procurement decisions, yet it is still required to approve annual work programs and PODs. It is common for regulators to condition their approval of budgets on certain conditions and the Masela controversy with respect to the development of a land-based or floating liquefied natural gas ('LNG') project provides an example of how such oversight can be used with dramatic consequences for a Contractor and a proposed development.[24] It is clear that this is a further area where practice will need to be developed over time and the uncertainty this gives rise to, both for Contractors and SKK Migas, is unlikely to accelerate decision-making in the short term in the absence of more detailed and prescriptive guidelines/regulations as to how SKK Migas is to exercise its authority.

Procurement

One area of particular concern is the procurement of goods and services. Historically, procurement has been regulated through Presidential decrees, the latest of which is Decree No. 80 of 2003 and Guidance No. 007/SKKO0000/2015/S0 on the Management Framework for the Supply Chain for Cooperation Contracts and the latest SKK Migas procurement guidelines, PTK 007 Revision 4, ('PTK 007'). The PTK 007 regime

22 Articles 15(2) and 15(3), Gross-Split PSC Regulation.

23 Article 23, Gross-Split PSC Regulation.

24 While an initial proposal to develop a floating LNG project in the Masela Block was approved by the ESDM in 2010, upon revision of the POD by Masela's operator in 2014 to, *inter alia*, increase capacity of the project from 2.5 to 7.5 MTPA, the Government required the Contractor to submit a revised POD to include an onshore LNG facility following political in-fighting between Government ministries, including between the ESDM and the Coordinating Ministry for Maritime Affairs and Resources. Proponents of the onshore development queried the soundness of FLNG technology and argued than an onshore development would be of greater benefit to the local economy. The upshot was that the Masela POD was modified to require the development of an onshore LNG plant. The project's development has been delayed by several years and the Government recently announced it would extend the Masela PSC for 20 years and provide the Contractors with an additional seven-year extension to compensate it for these delays resulting from the Government's decision. Amanda Battersby, 'Indonesia Sights on Abadi Plan Progress' *Upstream* (15 December 2017) <http://www.upstreamonline.com/hardcopy/1396227/indonesian-sights-on-abadi-plan-progress> accessed 22 December 2017.

required SKK Migas to approve procurement tenders over a certain amount and also only permitted certain qualified contractors to bid for the work. We understand that the procurement processes under PTK 007 will cease to apply to Gross-Split PSCs since Article 18(2) provides that 'the procurement of goods and services are conducted by Contractor independently'. However, the supervisory function reserved to SKK Migas raises questions as to whether or not Contractors will be free from interference in their procurement decisions. For example, Article 18(1) of the Gross-Split PSC Regulation states that Contractors must 'prioritise the use of a workforce of Indonesian citizens, the utilisation of domestic goods, services, technology, as well as national engineering and construction abilities'.

A number of regulations and decrees impose local content obligations, such as ESDM Regulation No. 15 of 2013, which largely codified the PTK 007 guidelines that existed at the time and set out new local content targets and sanctions, ESDM Decree No. 31 of 2013 on Expatriate Utilisation and the Development of Indonesian Employees in the Oil and Gas Business, and also parts of PTK 007, which mandate that Indonesian employees must be employed for certain functions (eg human resources and supply chain oversight) (the 'Local Content Requirements'). For example, ESDM Regulation No 15 of 2013 set local content targets of 30 per cent (onshore) and 45 per cent (offshore) for drilling-related activities. Compliance with these Local Content Requirements is considered in the gross-split regime since one of the variable components used to determine the gross-split is the usage of domestic goods and services (*Tingkat Kompnen Dalam Negeri*). Depending upon the level of local content used, an adjustment of up to 4 per cent can be made to the base split, but, aside from this provision, there are no other sanctions specified for non-compliance with Local Content Requirements.

There is tension between the objective of the Government to allow Contractors discretion as to how they conduct operations and the Local Content Requirements. For example, suppose a Contractor wishes to have FEED work undertaken by a vendor outside Indonesia at a price which is lower than that available from local vendors. Can SKK Migas require the Contractor to demonstrate how it will meet these Local Content Requirements at the time it submits its annual work program for approval? Could SKK Migas insist upon the use of a local vendor even if it imposes a higher cost?

The recent PTK 007 guidelines issued by SKK Migas, PTK007 Revision 4, maintain the tender/procurement processes and do little to clarify matters with respect to the Gross-Split PSC regime. SKK Migas representatives at a conference held in 2017 stated that, despite the word 'independently' in Article 18(2) of the Gross-Split PSC Regulation, Contractors would still need to comply with the Local Content Requirements and Indonesian competition law. Previously, the denial of cost-recovery was a powerful weapon that could be wielded by SKK Migas or auditors for non-compliance. At the same conference, SKK Migas representatives expressed the view that Contractors could be denied their additional split in the event the promised levels of local content were not met. However, what was not clear is why the 'sweetener' (as it was termed by the SKK Migas representatives) of an additional split percentage for satisfying local content requirements was needed if those requirements remained mandatory. ESDM Regulation 52 of 2017 confirms the statements of the SKK Migas representatives as the remarks column of the variable components table for domestic content states that these requirements are mandatory.

Compliance with Law 22 of 2001

There is a potential argument that SKK Migas' reduced 'control and oversight' function is inconsistent with Law 22 of 2001. Article 6(b) of Law 22 of 2001 provides that 'the management control of operations [under a PSC] shall be by the Implementing Body'. Further, Article 56 of Government Regulation No 35 of 2004 regarding Upstream Oil and Gas Business Activities ('Regulation 35 of 2004') provides that 'the investment and operating expenses incurred under the Production Sharing Contract shall be approved by the Implementing Body' and, further:

> The Contractor shall recover . . . the expenses it has incurred to carry out Exploration and Exploitation . . . according to the work plan and budget and the Authorisation of Financial Expenditure approved by the Implementing Body after the commercial production.

We understand that the ESDM/Government recognizes that appropriate revisions to these regulations will need to be made (and, of course, the replacement of Law 22 of 2001 and a draft new oil and gas law was announced in 2015, although this is still being deliberated upon by the Indonesian legislature). Notwithstanding this, the ESDM has left itself and the Gross-Split PSC Regulation exposed to possible judicial review actions with the Indonesian Supreme Court pending new laws and regulations being passed. It is also unusual as a legal matter for a regulation of such importance to be implemented by way of a ministerial regulation, which is subordinate as a matter of Indonesian law to Law 22 of 2001 and Regulation 35 of 2004, neither of which contemplate a gross-split PSC. Since Commission VII of the House of Representatives is tasked with the drafting of a new regulation to replace Law 22 of 2001 it is possible that opposition to the regulation could see it challenged and overruled if it meets with opposition from Commission VII and industry stakeholders, including Pertamina.

7. NEW AND EXPIRING PSCs AND GROSS-SPLIT CONVERSIONS

New and expiring PSCs

Government officials have stated that new PSCs will need to adopt the gross-split structure.[25] Article 24 of the Gross-Split PSC Regulation states that the gross-split structure will apply for any PSC which is not extended.

For those expiring PSCs in respect of which, at the time the Gross-Split PSC Regulation came into force (13 January 2017), an extension had *already* been approved, Article 25(b) of the Gross-Split PSC Regulation provides that the original PSC structure may continue to be used. However, in these circumstances, the PSC parties have the option to propose changing to the gross-split structure. Article 24(2) of the Gross-Split PSC Regulation provides that for those expiring PSCs which are extended, 'the Government may determine the same original Cooperation Contract or the Gross-Split Production Sharing Contract'. As such, the Government has discretion as to the imposition of a Gross-Split PSC, which is at odds with the statements made by Government officials.[26] In this respect, it was recently announced that the Masela PSC would be extended for 27 years until 2055. We understand that this will be structured as a 20 plus 7-year extension.[27] As far as we are aware, ESDM has not required the extension to take the form of a Gross-Split PSC which shows that it may be willing to exercise its discretion in favour of a Contractor wanting to extend its PSC or it could simply reflect the unique circumstances of the Masela PSC. However, Government officials have stated that the giant high CO_2 D-Alpha field (>46 tcf) in the East Natuna block should be developed using the Gross-Split PSC model. ExxonMobil, which had been a participant in the project, withdrew this year.

When deciding on the form and provisions of a PSC following an approved extension application, or when determining if the working area is to be awarded to Pertamina or the Contractor (or a combination of both), Regulation 15 of 2015 on the Operatorship of Oil and Gas Blocks for Production Sharing Contracts that are Going to Expire ('Regulation 15 of 2015') requires that regard be had to the 'benefits' to the

25 ESDM Deputy Minister, Arcandra Tahar, has stated that no new field can use cost recovery and that all fields must use the gross-split scheme (Fedina Sundaryani, 'All New Oil and Gas Contracts Must Use Gross-Split' *The Jakarta Post* (19 January 2017) <http://www.thejakartapost.com/news/2017/01/19/all-new-oil-and-gas-contracts-must-use-gross-split.html> accessed 23 November 2017). Similar statements have been made by other officials.

26 In practice, the willingness of the Government to grant such extensions in the PSC's original form is untested and so much will depend upon whether or not Pertamina is assuming operatorship of the extended PSC, in which case it is likely to be required to use the model Gross-Split PSC.

27 With the additional seven-year extension being granted in return for the imposition of a requirement to develop an onshore LNG facility.

Indonesian state.[28] Query, therefore, whether the Government/ESDM would be willing to grant PSC extension applications using the Cost Recovery System or if it will insist upon the use of the Gross-Split PSC model. Given that, in many cases, exploration and development costs for expiring PSCs will have been reimbursed through the Cost Recovery System, the costs that a Contractor will be attempting to recover during the term of any extended PSC will be predominantly operating costs or costs associated with secondary or tertiary recovery methods. Consequently, it is likely that the ESDM will expect a reduction in the profit split of the Contractor. If, on the other hand, the Contractor plans on making new investments (such as new PODs or engaging in secondary or tertiary production activities), then it may be able to argue that an equivalent or greater profit split is needed.

Gross-split conversions

In respect of any PSC signed prior to the enactment of the Gross-Split PSC Regulation, the Contractor has the option to convert to the gross-split structure. If an application is made to convert an existing PSC to a Gross-Split PSC, operating costs which have not been recovered may result in a discretionary split being determined by the Minster.[29] However, quite how this additional split will be calculated is unclear as there is no objective basis to convert a sum of unrecovered costs to an equity split adjustment so this process is likely to be contentious and subject to negotiation between Contractors and SKK Migas, unless the terms are simply 'imposed' upon the remaining Contractors. The position regarding the carry-forward of operating costs, however, appears more ambiguous where expiring PSCs are not extended (and will, therefore, be replaced by a Gross-Split PSC, as mentioned above) or where they are extended (and the form of PSC going forward is left to the discretion of the Government)—the Gross-Split PSC Regulation is, unfortunately, silent on this front. This is likely to cause consternation among industry participants, especially those with large unrecovered costs.

In an effort to address this uncertainty, ESDM Regulation No 26 of 2017 on Mechanism for Investment Cost Recovery in Oil and Gas Upstream Business Activities (as amended by ESDM Regulation No 47 of 2017, 'ESDM Regulation 26 of 2017') was implemented. It states that Contractors must conduct investments to maintain an equitable level of oil and gas production. If a PSC expires and is not extended, the new Contractor must compensate the former Contractor for any unrecovered 'Investment Costs' that remain at the end of the PSC.[30] ESDM Regulation 26 of 2017 defines 'Investment Cost' as costs expended by Contractors in the form of capital investment costs to carry out 'Upstream Investment Activities' prior to PSC expiry, which have been approved by SKK Migas. The regulation limits 'Investment Costs' to capital costs incurred in the five years period prior to the PSC expiry.[31]

ESDM Regulation 26 of 2017 is intended to ensure that Contractors continue to make capital investments to maintain production levels in the remaining years of their PSC recognizing that they may not do so unless they have an assurance that they will be able to fully recover the costs of such investments prior to its expiry. Upon conversion to a Gross-Split PSC, the Gross-Split PSC Regulation provides for an adjustment in favour of the Contractor in respect of such unrecovered costs by taking this into account in determining the Contractor share of the split from production.[32] The operation of the regulation raises a number of issues that have not been addressed so it is doubtful that it will achieve its objective until these are clarified. For example:

28 Articles 2(3)(f) and 22(1)(a), Regulation 15 of 2015.

29 Article 25(d), Gross-Split PSC Regulation. Prior to the amendment of the Gross-Split PSC Regulation, this adjustment was limited to a maximum of 5 per cent.

30 Article 6, ESDM Regulation 26 of 2017.

31 Article 7(1), ESDM Regulation 26 of 2017.

32 Article 5(2), ESDM Regulation 26 of 2017.

- What is the time period for reimbursement of unrecovered Investment Costs by a new Contractor?
- What happens if the new Contractor defaults in its obligation to reimburse such costs? Are these amounts guaranteed by the Government?
- If a PSC is converted to a Gross-Split PSC how are unrecovered 'Investment Costs' factored into the calculation of the Contractor's split percentage? If a Contractor has US$300 million in unrecovered capital costs an adjustment to its split will need to be considerable to equate to an adjustment in NPV terms that mirrors the cost-recovery reimbursement mechanism.
- What if a Contractor is not willing to continue operations using a Gross-Split PSC model?
- Why are some costs excluded from reimbursement both within and outside the final five years of a PSC?

Historically, these issues were avoided as it was customary for PSCs to be extended if production was continuing, albeit with an adjustment to the fiscal terms in the Government's favour and additional relinquishment obligations being imposed. The combined effect of the Gross-Split Regulation and ESDM Regulation 26 of 2017 is that Contractors face uncertainty as to (i) whether or not their PSCs will be extended and (ii) if so, whether the PSC will be extended in the form of a Gross-Split PSC or a conventional PSC. Unfortunately, this is likely to lead to reduced investment unless the Government addresses these issues several years prior to the scheduled expiry of PSCs. Since many of Indonesia's PSCs are due to expire in the next 5–10 years, this is an issue of industry-wide application and the resources of the Government, ESDM, SKK Migas and Pertamina will be stretched to handle so many difficult negotiations in parallel.

8. GROSS-SPLIT PSC ECONOMICS

We set out below two sets of diagrams comparing the economics of the Gross-Split PSC to a current generation PSC. Figure 3 shows the Government and Contractor take when there are high operating costs, and Figure 4 depicts a scenario when there are low operating costs.

As can be seen, in both cases, the returns to the Contractor in the Gross-Split PSC are worse. The effect of ensuring a guaranteed share of production to the Government, which would have normally only come after recovery of operating costs after First Tranche Petroleum, means that all (if operating costs are high) or a significant amount of the Contractor's production revenues are required to meet operating costs. As mentioned above, the Government's hope is that, by allowing Contractors to manage their costs without being subject to SKK Migas' procurement procedures and oversight of AFEs, Contractors will be able to significantly reduce their costs.

Further, the 'dynamic' nature of the gross-split outline above, whereby the Contractor's share of production will change during the term of the PSC based on fluctuating progressive components and a 'commercial evaluation' of the project may have a significant impact on the financial assessment of future revenue streams.

9. CONCLUSION—WHAT DOES THE FUTURE HOLD?

Royalties

Viewed from a fiscal perspective, the Gross-Split PSC has similar characteristics to a royalty regime and these have been successful elsewhere in the world. However, the economics of a royalty regime may not be well suited to Indonesia's oil and gas industry where there are a large number of low-margin, high-cost fields and very capital intensive projects located in deep water frontier areas. The Gross-Split PSC may provide improved economics for certain Contractors where they are producing from fields where there are low ongoing operating costs and where the relevant fields are located close to existing production and transmission infrastructure. As Benny Lubiantara observed at the time the idea of the Indonesian gross-split style PSC

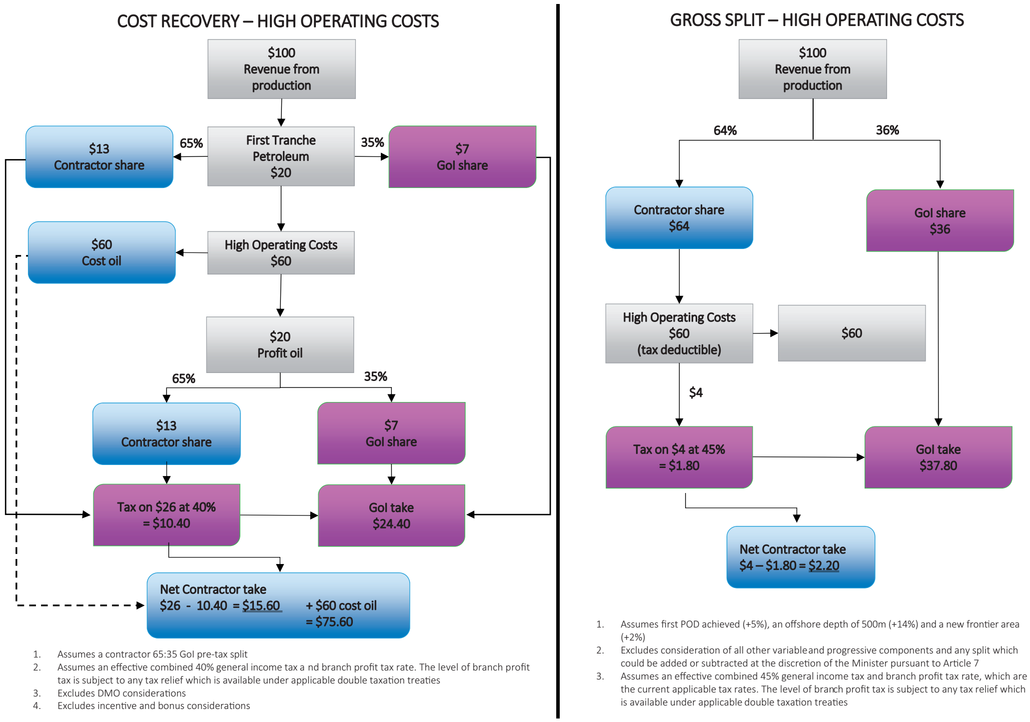

Figure 3. High operating costs.

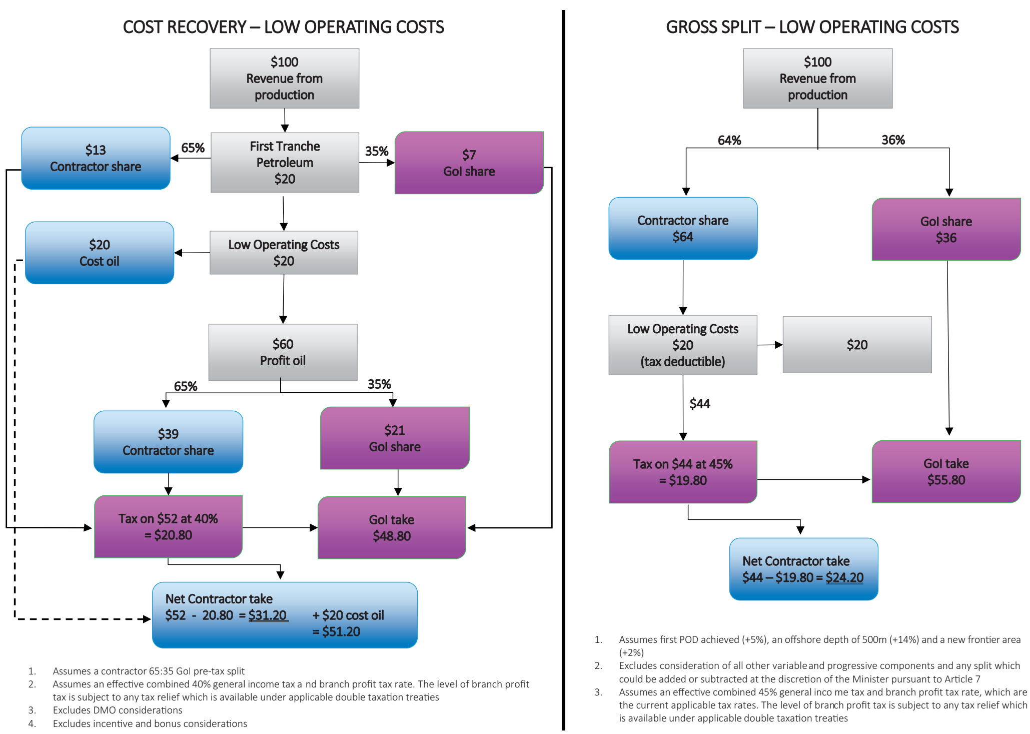

Figure 4. Low operating costs.

was initially mooted in 2011, 'a one-size-fits-all model does not exist'.[33] As far as royalty regimes go, the Government has also reserved itself one of the largest in the world—if the hypothetical entitlement example of 66.5 per cent used earlier in this article (which ignores progressive components) is taken as a reference, this would effectively leave the Government with a 33.5 per cent royalty. While this guarantees the Government more income in the short term, it will likely deter investment in the sector which is desperately needed to maintain production meaning that, in the long term, both the industry and the Government's take from it will continue to suffer.

Expiring PSCs

For those PSCs which are approaching expiry (and, therefore, will be replaced by a Gross-Split PSC if their term is not extended),[34] it will obviously need to be assessed how they will be affected by the Gross-Split PSC economics. As the waterfall diagrams above show, even where there are relatively low operating costs, the Contractor's economics under a Gross-Split PSC could be worse. Further, mature fields require significant costs in order to sustain continued productivity. Consequently, late life fields governed by a Gross-Split PSC may fail to attract the investment they need to continue production given the absence of cost recovery.

Time savings

Responding to research produced by Wood Mackenzie suggesting that the Gross-Split PSC may not be appealing to investors,[35] the ESDM Deputy Minister, Arcandra Tahar, argued that the time between discovery and first production will be considerably reduced through the independent procurement process and the removal of the bureaucracy associated with the cost recovery process. For Tahar, this time saving will result in improved economics, although until the taxation regime is clarified this cannot be evaluated.[36] It is possible he may be right as the first major gas discoveries in Indonesia were commercialized in less than eight years in the absence of regulatory bureaucracy, and one should never underestimate the ability of Contractors to 'fast-track' a development if the regulatory regime is conducive. The NPV benefit of production being brought forward by 5–10 years is substantial so any modelling of the Gross-Split PSC should take this into account. A recent example of a 'fast track' development is the 30 trillion cubic feet Zohr field in Egypt, which was discovered by Eni in 2015. Its plan of development was approved in the same year and production is expected to occur later this year. This process was assisted by Eni being granted a dispensation from having to conduct a competitive bid process for some of its construction contracts and demonstrates how quickly a development can be commercialized if the conditions are right and direct appointments can be made by Contractors.

Industry reaction

It is remarkable that a regulation of such importance came into existence in the space of less than three months and with such limited input from the industry and other stakeholders. The precision used to define the splits and the various adjustments thereto belies the fact that no one can explain how they were arrived at. What is known is that the IPA did not have time to provide meaningful input on the various adjustments contained in the Gross-Split PSC Regulation and Pertamina itself did not approve the splits to be used for the conversion of the blocks it is mandated to operate following their conversion to a Gross-Split PSC. The lack of co-ordination between the EDSM, the Ministry of Finance and Pertamina is lamentable as the

33 Benny Lubiantara, 'Comment on Opinion by Prasodjo et al: Turning Petro Dollars Back on: A Game Theory Approach' (*Ekonomi-Migas*, 6 October 2011) <http://ekonomi-migas.blogspot.co.id/2011/10/comment-on-opinion-by-prasodjo-et.html> accessed 23 November 2017. Interestingly, he also observed that there is no support for the hypothesis that Contractor's costs will be lower in a royalty regime than in a PSC regime.

34 See commentary above in this respect.

35 Note that this research was conducted prior to the revisions of the Gross-Split PSC Regulation made by ESDM Regulation 52 of 2017.

36 Galih Gumelar, 'ESDM Tuntut Wood Mackenzie Revisi Riset PSC Gross Split' *CNN Indonesia* (27 March 2017) <www.cnnindonesia.com/ekonomi/20170327085528-85-202926/esdm-tuntut-wood-mackenzie-revisi-riset-psc-gross-split/> accessed 23 November 2017.

uncertain regulatory environment has paralyzed the current bid round and created uncertainty for all expiring PSCs that have been ear-marked for conversion to a Gross-Split PSC and take-over by Pertamina.

Contractors will conduct their own sensitivity analysis on the economics of each model and decide whether or not they believe the Gross-Split PSC is an improvement. Cost savings will take time to harness and the willingness of SKK Migas to relinquish its control over procurement activities will require its co-operation at a working level. The local services market is unlikely to reduce its costs simply to preserve the economics of its customers. As a result of the regulatory uncertainty regarding the implementation of the Gross-Split PSC model and the associated tax regime and the ability of existing Contractors to have their PSCs extended or if they will be turned over to Pertamina, investment plummeted to only US$4 billion in the first half of 2017 compared to a target of US$13.8 billion.[37] Companies have adopted a 'wait and see' approach until there is greater clarity on these issues. Unless these issues are resolved, the loss of investor confidence may have a devastating effect on the industry and many industry observers privately fear that this could be the case. The IPA has reportedly recommended that the Gross-Split PSC should be optional rather than mandatory for new PSCs, although it is unlikely that the ESDM will change its position unless there is intervention from sources outside the Ministry. This view was recently confirmed by a spokesperson from the Ministry who claimed that only the 'figures' would be adjusted in the Gross-Split PSC model and stated: 'The recipe is already correct, now it's time to adjust the dosage'.[38] To continue the metaphor, there remains a risk that the patient may not recover from the incorrect prescription so it may be time to try a different recipe or return to the recipe that successfully built the petroleum industry in Indonesia by applying the adage 'if it ain't broke, don't fix it'.

Unless the issues identified in this article with respect to the operation of the Gross-Split PSC Regulation are addressed quickly, it is likely that new investments will not be made and exploration expenditures will continue to decline, which will result in a further reliance on imported crude oil and eventually LNG. Indonesia may soon be forced to import LNG to meet its energy needs, which would be an outcome that has serious long-term economic and security implications for the country and a reversal for a country that just over 10 years ago was the leading LNG exporter in the world.

10. POST-SCRIPT

Following the finalization of this article, it was reported that Premier Oil, together with Mubadala and Kris Energy, had been awarded the Andaman II block, Mubadala the Andaman I block, and Saka Energi the Pekawai and West Yamdena blocks as a result of Indonesia's 2017 bidding round using the Gross-Split PSC model.[39] This is encouraging given the uncertainty associated with the fiscal and tax regime and indicates a degree of acceptance of the new model. As we have highlighted in our article, one of the uncertainties was the status of the 'Uniformity Principle' which previously meant that costs recoverable under the Cost Recovery System were also tax deductible. On 28 December 2017, the Government issued its long awaited Government Regulation No. 53 of 2017 regarding the treatment of income tax with respect to Gross-Split PSCs (the 'Tax Regulation'). The Tax Regulation confirms the principle of deductibility of operating costs from Contractor income, which for these purposes will include oil and gas lifting revenues, by-product sale revenues and 'any other income that gives additional economic benefits'.[40] It remains to be seen how broadly operating costs are interpreted for these purposes, especially given some of the broad language used in the

37 Battersby (n 19).

38 Fedina Sundaryani, 'PHE Earns Bigger Slice Under "Gross-Split"' *The Jakarta Post* (23 August 2017) <http://www.thejakartapost.com/news/2017/08/23/phe-earns-bigger-slice-under-gross-split.html> accessed 23 November 2017.

39 Wilda Asmarini, 'Indonesia picks five winners in 2017 energy tender' *Reuters* (31 January 2018) <https://af.reuters.com/article/commoditiesNews/idAFL4N1PQ45J> accessed 1 February 2018; Steve Marshall, 'Premier wins Indonesia block' *Upstream* (31 January 2018) <http://www.upstreamonline.com/live/1423341/premier-wins-indonesia-block> accessed 31 January 2018.

40 Articles 18(1) and 4(3)(d), Tax Regulation.

Tax Regulation.[41] We note that operating costs are required to fulfill various requirements in order to be tax deductible, one of which is that the activities are based on an SKK Migas-approved work program and budget.[42] This requirement is curious as it appears to conflict with the provisions of the Gross-Split PSC Regulation discussed in our article in relation to SKK Migas not having to approve the budget. Taxable income will then be subjected to prevailing general tax regulations. The Tax Regulation provides for the carry-forward of losses for a period of up to 10 years (five years being the period under general Indonesian tax law).[43] A number of tax incentives have also been introduced in respect of the period leading up to production, including the exemption of import duties and certain VAT payment exemptions.[44] However, implementing regulations are still necessary for certain areas so the tax regime is still under development.

The ESDM is pressing ahead with a new bid round for 2018, which is due to commence mid-February 2018 and will include 40 blocks, most of which were offered without success in prior bid rounds. The new bid round may well be a litmus test for the Gross-Split PSC and its new taxation regime and so the jury may still be out on the acceptance of the Gross-Split PSC. If it is a success then the Government will be able, with some justification, to silence some of its critics and investors will become pioneers of a new PSC model that may reinvigorate much needed investment in the oil and gas sector in Indonesia.

Table 3. Gross-split PSC regulation—variable and progressive components[a]

Variable component	*Entitlement split percentage change*	*Remarks*
Status of field	+5% (for POD I) +3% (for POD II)	In the event production in soon-to-be terminated working area continues without POD, there is a 0% revision to the entitlement split.
Location of field	0% (Onshore) 8 to 16% (Offshore)	Offshore percentages depend on sea depth, as follows: • Below/equal to 20 metres: +8% • Above 20 metres, but below/equal to 50: +10% • Above 50 metres, but below/equal to 150: +12% • Above 150 metres, but below/equal to 1000: +14% • Above 1000 metres: +16%
Depth of reservoir	1%	If vertical depth of wells exceeds 2500 metres.
Availability of supporting infrastructure	0% (Well developed) 2% (New frontiers—Offshore) 4% (New frontiers—Onshore)	Increased percentage only awarded where supporting infrastructure (such as roads) is not available.
Reservoir type	0% (Conventional) 16% (Unconventional)	Increased percentage for coal-bed methane and shale reservoirs.

(*continued*)

41 Article 5(5)(e) of the Tax Regulation, for example, includes 'other costs relating to the Oil Operations' as operating costs, although we note that any such costs need to further satisfy the requirements in Article 7 of the Tax Regulation, including being based on an approved work program and budget.

42 Article 7(1)(d), Tax Regulation.

43 Article 18(2), Tax Regulation.

44 Article 25, Tax Regulation.

(continued)

Variable component	*Entitlement split percentage change*	*Remarks*
CO_2 content	0 to 4%	Increased percentage dependent on percentage of CO_2 content above 5%, as follows: • Below 5%: +0% • Above/equal to 5%, but below 10%: +0.5% • Above/equal to 10%, but below 20%: +1% • Above/equal to 20%, but below 40%: + 1.5% • Above/equal to 40%, but below 60%: + 2% • Above/equal to 60%: + 4%
H_2S content	0 to 5%	Increased percentage dependent on H_2S content above 100 ppm, as follows: • Below 100ppm: +0% • Above/equal to 100ppm, but below 1000: +1% • Above/equal to 1000ppm, but below 2000: +2% • Above/equal to 2000ppm, but below 3000: +3% • Above/equal to 3000ppm, but below 4000: +4% • Above/equal to 4000ppm: +5%
Gravity	1%	Increased percentage if specific gravity above 25 API.
Local content	0 to 4%	Increased percentage dependent on level of local content usage based on existing regulations (please see commentary in article in respect of local content requirements), as follows: • Below 30%: +0% • Above/equal to 30%, but below 50: +2% • Above/equal to 50%, but below 70: +3% • Above/equal to 70%, but below 100: +4%
Stage of production	0 to 10%	Increased percentage dependent on whether primary, secondary or tertiary production, the latter including enhanced oil recovery, as follows: • Primary: +0% • Secondary: +6% • Tertiary: +10%
Progressive component		
Oil price	Formulaic-based approach	(85 – ICP) × 0.25ICP is the Indonesian Crude Oil Price determined by the ESDM in accordance with applicable laws and regulations.

(*continued*)

(continued)

Variable component	*Entitlement split percentage change*	*Remarks*
Gas Price	Formulaic-based approach	• Price below 7 US$/MMBTU: (7 − Gas Price) × 2.5 • Price above/equal to 7 to 10 US$/MMBTU: 0% • Price above 10 US$/MMBTU: (10 − Gas Price) × 2.5
Cumulative production	0 to 10%	Range depends on cumulative production (in MMBOE), as follows[b]: • Below 30: +10% • Above/equal to 30, but below 60: +9% • Above/equal to 60, but below 90: +8% • Above/equal to 90, but below 125: +6% • Above/equal to 125, but below 175: +4% • Above 175: +0%

[a]The table reflects the variable and progressive components set out in the Gross-Split PSC Regulation, as amended by ESDM Regulation 52 of 2017. ESDM Regulation 52 of 2017 made several increases to the production-split adjustments set out in the Gross-Split PSC Regulation. For example, it doubled the production entitlements for secondary and tertiary stages of production. Perhaps more strangely, the split entitlements for onshore frontier areas were revised upwards by 2–4 per cent whereas offshore frontier areas were kept at 2 per cent—this is peculiar since we would have expected offshore costs to be more. In addition, formulaic approaches were introduced with respect to crude oil prices (whereas previously there were fixed price brackets). In certain instances, the equation-based approach to determining the entitlement adjustment in respect of crude oil is more favourable.

[b]The progressive components remarks column inserted by ESDM Regulation 52 of 2017 provide that: (i) for expiring PSCs which are extended using the Gross-Split PSC model, the production levels continue once the Gross-Split PSC comes into effect (ie the cumulative production level is not reset), and (ii) for Contractors which apply to have their PSCs converted into a Gross-Split PSC, the cumulative production levels are reset and start from zero from the effective date of the new Gross-Split PSC. Although the reason for the distinction is not apparent, we suspect this stipulation has been introduced in order to incentivise Contractors to convert their PSCs into Gross-Split PSCs so as to benefit from the increased production split they will be awarded, rather than wait until PSC expiry.